IN THE

Supreme Court of the United States.

October Term, 1960
No. 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR PETITIONERS.

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OPINIONS BELOW.

The District Court did not write an opinion. Instead, it issued, on October 20, 1958, an oral opinion [R. 103, 104], which was followed on November 5, 1958, by written findings of fact and conclusions of law. [R. 55-62.] The opinion of the Court of Appeals [R. 111-114], is reported at 272 F. 2d 200.

JURISDICTION.

The judgment of the Court of Appeals was entered on November 16, 1959. [R. 111.] The petition for certiorari, filed on December 21, 1959, was granted on February 23, 1960, 360 U. S. 958. Jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

QUESTION PRESENTED.

Whether the courts below have the power to disallow as a deduction from gross income interest paid on indebtedness incurred to purchase and carry a single premium annuity acquired before March 1, 1954, in view of the clear intent of Congress when in 1954 it amended Section 24(a)(6) of the 1939 Internal Revenue Code, and explained the amendment saying:

> . . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment afforded single-premium life-insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity.
>
> The (Your committee's) bill *will* deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954. H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). (Emphasis supplied.)

STATUTES INVOLVED.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) General rule.—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * * * *

(6) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a

single premium life insurance or endowment contract.

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) General Rule.—No deduction shall be allowed for—

* * * * * * * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

STATEMENT.

This proceeding began as a civil action seeking a refund of federal income tax paid by petitioners for the years 1953 and 1954. It originated in the United States District Court for the Southern District of California. District Judge William C. Mathes held in favor of the respondent. The Court of Appeals affirmed.

On December 11, 1953, Karl F. Knetsch, hereafter called Knetsch or the petitioner, purchased ten separate single premium annuities from the Sam Houston Life Insurance Company of Houston, Texas. [R. 35, 56.] The purchase price of each annuity was $400,400 or a total of $4,004,000 for all ten annuities. [Exs. 1-12, R. 33, 34, 71.] The total purchase price was paid by Knetsch's delivery to Sam Houston of his check for $4,000 and by borrowing $4,000,000 from Sam Houston. [R. 56; Exs. 1-22, R. 33, 34, 71.] As evidence of the $4,000,000 debt, Knetsch executed and delivered to Sam Houston ten individual contract loan agreements, each in the principal sum of $400,000. [R. 56; Exs. 13-22, R. 34, 71.] Each of the ten contract loan agreements provided that interest, at a rate specified in the respective annuity contracts of 3½% per annum, must be paid in advance. [Exs. 13-22, R. 34, 71.] Therefore, on December 11, 1953, Knetsch delivered to Sam Houston his cashier's check for $140,000 which amount is 3½% of $4,000,000. [R. 57; Ex. 23, R. 34, 71.] This sum of $140,000 constitutes the bulk of the $143,465 which Knetsch claimed as an interest deduction for the

year 1953. [R. 39.] The additional $3,465 was paid to Sam Houston by Knetsch on or about December 16, 1953, as a result of the transaction described in the following paragraph.

On or about December 16, 1953, Knetsch borrowed and received an additional sum of $99,000 from Sam Houston and agreed to pay interest thereon at the rate of 3½% per annum. [R. 28-40; Ex. 25, R. 34, 71.] Thus, on or about December 16, 1953, Knetsch delivered to Sam Houston his check for $3,465 which amount is 3½% of $99,000. [R. 38, 39; Ex. 36, R. 34, 71.] Concurrently with the payment of the $3,465 to Sam Houston, Knetsch delivered to Sam Houston ten separate contract loan agreements, each in the principal amount of $9,900. [R. 38; Exs. 26-35, R. 34, 71.] It is this $3,465 payment of December 16, 1953, plus the $140,000 payment of December 11, 1953, which comprise the total of $143,465 deducted by petitioners as interest paid to Sam Houston during 1953. [R. 39; Exs. 23, 36, R. 34, 71.]

In short, Knetsch purchased each of the ten single premium annuities for a nominal cash payment ($400) with a loan to cover the balance of the cost ($400,000) of the annuity. This is precisely the transaction which is described in the 1954 Senate Finance Committee and House of Representatives Ways and Means Committee reports quoted above.

During the following year, 1954, the $4,000,000 loan was renewed by Sam Houston and Knetsch delivered

another cashier's check in the sum of $143,465 to Sam Houston. [R. 39-41, 57; Ex. 49, R. 35, 71.] In addition Knetsch increased the $99,000 loan by the sum of $104,000 to $203,000 and paid interest thereon of $3,640. [R. 39-41, 57; Exs. 38-47, 50, R. 34, 35, 71.] It is the $143,465 plus the $3,640 or a total of $147,105 which petitioners deducted as interest paid to Sam Houston during 1954. [R. 39.]

In December of 1955, Knetsch again executed and delivered new annuity loan notes increasing the $203,000 loan to $307,000, and again paid interest upon the renewed loan of $4,000,000 plus the $307,000 to Sam Houston. The interest paid was $150,745. [R. 40.] This sum of $150,745 was claimed by petitioners on their 1955 return. [R. 40; Ex. 70, R. 37, 71.]

Thereafter, on December 27, 1956, Knetsch surrendered the ten single premium annuities to Sam Houston and received therefor a cancellation of the $4,307,000 indebtedness plus a check for $1,000 [R. 40.]

On their 1956 federal income tax return petitioners claimed a deduction of $138,315 as a Section 165 loss realized upon the surrender of the ten single premium annuities. [R. 41.] This sum of $138,315 was in error by $1,000 since it did not take into account the $1,000 received by Knetsch at the time of the surrender. Therefore, the correct amount of the claimed loss should be $137,315. The $137,315 loss is computed as follows [R. 41]:

Interest deducted on returns:		
1953	$143,465	
1954	147,105	
1955	150,745	
	$441,315	
Cash paid at time of purchase	4,000	
	$445,315	
Less:		
Amounts received from company		
1953	$ 99,000	
1954	104,000	
1955	104,000	
1956	1,000	
	$308,000	$137,315

In 1956, the Commissioner of Internal Revenue issued a statutory notice of deficiency to the petitioners disallowing the interest deductions claimed by them in 1953 and 1954 saying that such payments "are not interest within the meaning" of Section 23(b) of the 1939 Internal Revenue Code and Section 163 of the 1954 Internal Revenue Code. [R. 13-15.] Subsequently, the asserted deficiencies were paid and this suit for refund was filed in the United States District Court. District Judge William C. Mathes held in favor of the Government and the Court of Appeals affirmed.

It should be noted that although neither the year 1955 nor the year 1956, during which latter year the annuities were surrendered, are before the Court, both have an important bearing upon this appeal. The reason is that when this transaction is viewed as a closed transaction, it becomes perfectly apparent that the Government's "tax avoidance" argument is simply not supported either by mathematics or the record. Instead, and as will be shown hereafter, the petitioners have sustained, as a result of the annuity transactions, a net cash loss of $50,650.36 even if the interest deductions claimed for 1953, 1954 and 1955 are all allowed in full.

SUMMARY OF ARGUMENT.

The courts below had no power to disallow the interest paid by petitioners to purchase and carry single premium annuities acquired before March 1, 1954, because the Congress of the United States had already preempted the field in 1954 and decided that such interest was a proper deduction. That is, the Congress of the United States has enacted legislation dealing with the particular problem which was before the courts below, and has clearly stated that payments such as those made by Knetsch, not only constituted interest but were allowable as deductions if paid to purchase and carry a single premium annuity acquired on or before March 1, 1954. Section 264(a)(2), Internal Revenue Code of 1954; H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954).

The tax avoidance motive does not exist in this case.

ARGUMENT.

I.

The District Court and the Court of Appeals Were Without Power to Disallow the Claimed Interest Deduction Since Congress, in 1954, Preempted the Field and Decided That Such Items Were Interest and Constituted a Proper Deduction.

Whether the interest deductions claimed in this case are allowable depends upon what the Court believes is the proper role to be played by the judiciary under our system of government. This is so because the Congress of the United States has already legislated on the specific problem which was before the District Court and the Court of Appeals for the Ninth Circuit and has clearly stated that payments, such as those made by Knetsch, not only constituted interest but were allowable as deductions from gross income if paid to purchase or carry an annuity acquired on or before March 1, 1954. Section 264(a)(2), Internal Revenue Code of 1954; H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). Thus, to sustain the District Court and the Ninth Circuit, it would be necessary for the Court to contravene, both in spirit and in substance, the decision which has already been made by the Congress regarding the particular deduction involved here.

Although this Court is not bound by the decisions of the Circuit Courts of Appeals, nevertheless, it is significant that one United States Court of Appeals, the Fifth Circuit, in a case involving the same insurance company, identical annuity contracts, and the same

method of purchase, as is presented here, in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, refused to so contravene the action taken by the Congress, saying instead at page 584:

> We emphasize that whether and to what extent interest deductions are to be permitted involves consideration of many complex, intricate, and sometimes technically significant factors which Congress, the weaver, evaluates as it weaves and unweaves the seamy web men call tax law. In that process Congress has purposefully distinguished between annuity contracts and the other two. In that light Sections 23(b) and 24(a)(6) reflect a purpose to treat *payments of the kind made here as interest and allow them as a deduction.* (Emphasis supplied.)

After the 1958 *Bond* decision, *supra,* the Third Circuit, in the 1959 decision of *Weller v. Commissioner* (C. A. 3, 1959), 270 F. 2d 294, refused to follow *United States v. Bond, supra,* adopting instead the dissenting opinion of U. S. Circuit Judge Wisdom in the *Bond* case, *supra.* Subsequently, the Ninth Circuit decided this case and agreed with *Weller v. Commissioner, supra.* Finally, on July 5, 1960, the Second Circuit, with a vigorous dissenting opinion by U. S. Circuit Judge Moore, in the case of *Diggs v. Commissioner* (C. A. 2, 1960), ...F. 2d ...., 60-2 USTC Par. 9584, joined the Third and Ninth Circuits.

Thus, the issue is posed. Which of the competing opinions, *United States v. Bond, supra,* or *Weller, Knetsch* and *Diggs, supra,* reflect the intention of Congress with respect to the issue before the Court?

In order that an intelligent answer to the above question be reached, it is necessary to examine the language of the applicable statutes and the legislative history of the statutes before turning to the cases.

The Statutory Language.

Section 23(b) of the 1939 Internal Revenue Code and Section 163 of the 1954 Internal Revenue Code both allow, as a deduction from gross income:

> *All* interest paid or accrued within the taxable year on indebtedness. (Emphasis supplied.)

However, Section 24(a)(6) of the 1939 Code provided for an exception to Section 23(b) saying that no deduction was to be allowed in respect of:

> Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium *insurance* or *endowment* contract. (Emphasis supplied.)

In 1954 the disallowance was extended by Section 264 (the successor to Section 24(a)(6) of the 1939 Code) to cover annuities. The applicable language provides that no deduction shall be allowed for:

> (2) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance, endowment, *or annuity* contract.
>
> Paragraph (2) shall apply in respect of annuity contracts *only* as to contracts purchased *after* March 1, 1954. (Emphasis supplied.)

In other words, until Section 264 of the 1954 Code was adopted, there was no question that interest paid

on indebtedness incurred to purchase an annuity was an allowable deduction. In fact the Commissioner of Internal Revenue issued rulings to this effect.[1] However, in the fall and early Winter of 1953, the Commissioner of Internal Revenue asked Congress to change the law.

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[1]See Exhibit 63. Also, one of these rulings appeared in the 1947 Prentice-Hall Tax Service at paragraph 16,145 as follows:

"Interest on loan obtained to purchase a single premium annuity contract.—

"The observation at Par. 6414-7 that the prohibition against the deduction of interest on a debt incurred to buy single premium life insurance or endowment contracts does not extend to annuities receives added confirmation in the following letter ruling from the Treasury Department:

"'Reference is made to your letter of July 14, 1947, in which you request a ruling with respect to the deductibility, for Federal income tax purposes, of interest paid on a loan obtained to purchase an annuity contract. A copy of the proposed contract and a copy of a Bureau ruling accompanied your letter of July 14, 1947.

"'The contract, which you are contemplating entering into with The Great-West Life Insurance Company of Winnepeg, Canada, provides for the payment of a single premium of $25,000 in return for which the Company will pay a life annuity of $284.58 monthly, the first payment to be made on the maturity date, July 7, 1965. Upon your death prior to the due date of the first annuity payment the Company agrees to pay to your wife a sum equal to the premium of the policy or the cash surrender value of the policy at the time of your death as determined from Table A of the policy, whichever is greater.

"'Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness, with certain exceptions not here material.

"'Based upon the information submitted, it is the opinion of this office that if you purchase a contract with the photostatic copy submitted with your letter of July 14th, 1947, the interest paid or accrued on a loan obtained to pay the premium thereon will be allowable as a deduction under Section 23(b) of the Internal Revenue Code.'

(Letter signed E. I. McLarney, Deputy Comm. 88 47)."

See further detailed discussion in *Amicus Curiae* brief filed herein.

The Legislative History of the Statute.

When the Commissioner of Internal Revenue asked the Ways and Means Committee of the U. S. House of Representatives to broaden the disallowance of certain interest payments to include situations where indebtedness was incurred to purchase a single premium annuity, he supported his request by citing the Committee to the very transaction now before the Court. Thus, the Ways and Means Committee Report, *supra*, states on page 31 that:

> . . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a *loan* to cover the balance of the single-premium cost of the annuity. *Interest on the loan* (which may be a *nonrecourse* loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity. (Emphasis supplied.)

In short, Congress, acting through the Ways and Means Committee of the House of Representatives and the Finance Committee of the Senate, was fully aware of the transaction now before this Court.

But what did Congress give to the Treasury as opposed to what it was asked to do? The answer is in the statute itself, Section 264, and the sentence of the Ways and Means Committee Report, *supra*, immediate-

ly following the above quoted Committee language. The report, after describing the annuity transaction involved herein said on page 31:

> Your committee's bill will deny an interest deduction *in such cases but only as to annuities purchased after March* 1, 1954. (Emphasis supplied.)

Thus, Congress gave the Commissioner only half of the apple. It said: You are now able to deny the interest deduction "in such cases" if the annuity is purchased after March 1, 1954, but you may not deny an interest deduction "in such cases" if the taxpayer acquired the annuity on or before March 1, 1954. Thus, Congress thereby protected taxpayers who had already contracted to pay an insurance company a fixed amount of interest to purchase a single premium annuity during the time when the law permitted a deduction for interest paid to purchase a single premium annuity.

However, the Commissioner of Internal Revenue, discovering on or before March 9, 1954, (the day upon which the Ways and Means Committee bill was sent to the floor of the House of Representatives) that his request for remedial legislation had been granted only in part, refused to abide by the decision of the Ways and Means Committee and determined to seize the other half of the apple by creating a legal issue to submit to the courts so that payments made "in such cases" could be disallowed even where the annuity was purchased on or *before* March 1, 1954. Therefore, on March 17, 1954, eight days after the Ways and Means Committee provision reached the floor of the House of Representatives, the Commissioner issued Revenue Ruling

54-94.[2] (App. A, *infra.*) This Revenue Ruling, which was the Commissioner's opening move to avoid the effect of Congress' refusal to retroactively legislate against the interest deduction "in such cases," held that such payments were not to be allowed as interest deductions.

In other words, after telling the Congress that the type of annuity purchase described in the above quoted Committee report necessitated a specific amendment to disallow interest paid on such nonrecourse loans and after obtaining legislation authorizing such a disallowance but with respect *only* to annuities purchased after March 1, 1954, the Commissioner reversed his field and said, in Revenue Ruling 54-94, that these payments never constituted interest to begin with, and, therefore, were not allowable whether the annuities were purchased after March 1, 1954, or not. When this revenue ruling is read, it will be observed that it contains the same approach urged upon, and rejected by, the Fifth Circuit in *United States v. Bond, supra,* but adopted by the courts below.

The Response of the Courts to the Above Legislative History.

Although the first opinion rendered in any of the Circuit Courts of Appeal agreed with the above legislative analysis, the court below, after stating that the problem was whether petitioners' payments were payments of interest, adopted the opinion of the Third Circuit in *Weller v. Commissioner, supra.* In the *Weller* opinion,

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[2]1954 Int. Rev. Bull. No. 11 at 6 (1954), 1954-1 Cum. Bull. 53.

he above legislative history was "answered" by the fol-owing:

> . . . However, such a showing is far from determinative of the issue in the case, for Section 24 (a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, *therefore,* legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible. (Emphasis on "therefore" supplied.)

The above language from the *Weller* opinion is the same technique which was used by the dissenting opinion in *United States v. Bond, supra,* where Judge Wisdom said:

> With all due deference to my able associates, it seems to me that the majority opinion does not meet the issue squarely.
>
> The case presents the question: Were the amounts the taxpayer paid the insurance company interest under Section 23(b)? This question is not answered by showing that Section 24(a)(6) does not prohibit deductions for amounts paid on indebtedness to purchase an annuity contract, as distinguished from a life insurance or endowment contract. Section 24(a) applies to specific items that are not deductible. It does not purport to say what items are deductible. As I see it, regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b). (At p. 584.)

In other words, Judge Wisdom, and the Third Circuit say that no matter what Section 24(a)(6) provides, the payments involved must still qualify as interest under Section 23(b). This is true, insofar as the statutory language itself is concerned, but does such a statement refute the 1954 Committee language showing that Congress has already legislated with respect to the particular problem involved? The Third Circuit and Judge Wisdom conclude that since the quoted Committee language appeared in an explanation of Section 264 of the 1954 Code, the successor to Section 24(a)(6) of the 1939 Code, such Committee language did not answer the question of whether the payment involved herein constituted interest under Section 23(b) and 163. Is this correct? For the following reasons, petitioners submit that such a conclusion is wholly without support.

In the first place, if the payments involved herein and described in the Committee reports explaining Section 264 did not constitute interest under Section 23(b) of the 1939 Code and Section 163 of the 1954 Code, why did the Commissioner ask Congress to disallow such interest "in such cases" in Section 264?

Secondly, the following language from both the Ways and Means Committee Report, *supra*, and the Senate Finance Committee Report, *supra*, clearly shows that Congress, along with the Commissioner, concluded that the payments "in such cases" did constitute interest:

> Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity

contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. *Interest* on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954. (H. Rep. at p. 31; S. Rep. at p. 38). (Emphasis supplied.)

When the above language refers to "*interest* on the loan . . . taken as a deduction," after describing the method of purchase used herein, it is certainly saying that there is interest within the meaning of Section 23(b) since that is the only section allowing interest as a deduction. Furthermore, the above phrase "Your committee's bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954," when read in conjunction with the first sentence thereof that "existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase a single-premium annuity contract," surely demonstrates that the respective Committees had concluded that existing law (Sec. 23(b)) allowed an interest deduction "in such cases." Since the phrase "in such cases" refers to the description of the very method of purchase of single-premium annuities now before this Court, it can hardly be said that the Committee language sheds no light on

the question of whether the payments involved herein did or did not constitute interest under Section 23(b). Also, what is the meaning of the Committee language that "an interest deduction *will* be" denied "in such cases" but only as to annuities purchased after March 1, 1954, if such payments never constituted interest under Section 23(b) as the Commissioner now contends?

Therefore, while it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b), it does not at all follow that the Committee language explaining Section 264 (the successor to Sec. 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" *as* interest and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954.

In disposing of the problem presented herein in the manner adopted, Congress has merely followed its usual practice in the income tax field of not legislating retroactively so that taxpayers who have relied upon existing law would not be penalized. This is a basic rule of fair play.

When the language of the above Committee reports is read along with the phrasing of Section 264, it is patently clear that Congress has already preempted the field and ruled that the payments made by petitioner not only constitute interest but are allowable as a deduction since his annuity contracts were purchased before March 1, 1954. It may be that a court, being composed of human beings who are also taxpayers, would conclude that Congress was wrong when it preserved the interest dedu-

tion "in such cases." However, it is submitted that while it is often necessary for a court to make policy when Congress has not spoken, it is neither necessary nor desirable for a court to contravene the expressed policy of Congress unless a constitutional right has been infringed upon. If it were, the provisions allowing percentage depletion and capital gain treatment would not have had a long life.

Nor is the conclusion that Congress intended such payments to be deductible supported only by the majority in *United States v. Bond, supra.* U. S. Circuit Judge Moore, in *Diggs v. Commissioner, supra,* wrote a strong dissenting opinion in which he stated:

> Congress, however, has in this case disclosed a clear intent that interest on annuity indebtedness now is not to be excepted because in finally reversing its policy of 1934 in 1954, it enacted Section 264 of the Internal Revenue Code of 1954, providing:
>
> "(a) General rule—No deduction shall be allowed for—
>
> * * *
>
> "Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Using only the plain meaning of the words as a guide, the prohibition does not apply to contracts purchased before March 1, 1954, as here. The Commissioner is forced to avoid this obvious conclusion

by arguing that even though annuity indebtedness interest was deductible, the transaction lacked reality. At this stage, the argument is back to the point of beginning. The Commissioner is not construing the law but rather imposing his views as to the method of handling the annuity purchase.

I recognize that in *Weller v. C. I. R.* 3 Cir., 1959, 270 F. 2d 294 [59-2 USTC Par. 9667], the Commissioner prevailed on a similar policy, the court rejecting the decision of the Fifth Circuit in *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577 [58-2 USTC Par. 9716]. The Ninth Circuit has recently affirmed the Commissioner's position in *Knetsch v. United States*, 9 Cir., 1959, 272 F. 2d 200 [59-2 USTC Par. 9767], certiorari granted, 360 U. S. 958 (1960). The rationale of these decisions appears to be based upon the assumption in the dissenting opinion of Judge Wisdom in the *Bond* case that "since no money or other economic benefits were advanced to the taxpayer by the Company, the payments were not interest." (258 F. 2d 577, 584-585).

But in our present-day commercial system, money is not "advanced" in the sense of delivery. A bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never sees money or securities. The margin account taxpayer does not take his interest each month and hand it to his broker. His account is debited; his loan thus increased. Here Standard was no different than a lending bank. Its books were subject to audit undoubtedly by one or more governmental agencies. Its premium account was credited when the payment was made

just as if the taxpayer had borrowed from a neighboring bank and handed the money through a cashier's window. Under such circumstances the interest would have been deductible. Surely application of the tax laws does not depend upon the source of the borrowing. Here the taxpayer and the Insurance Company were not taking advantage of a statutory loophole. "Loophole" connotes an inadvertent omission or oversight. Congressional action clearly indicates that between 1934 and 1954 interest on annuity indebtedness was intentionally not excluded. Taxpayers should be able to rely on the law. . . .

Surely there is merit to the position that when Congress has spoken on matters of internal revenue law, the courts should apply the decision even if they disagree with it.

II.

The Tax Avoidance Motive Does Not Exist Here.

Throughout the opinion in *Weller v. Commissioner, supra*, and the government's briefs in this case, there runs the recurring theme that the taxpayer either cannot or *should* not obtain the claimed interest deductions where his sole or primary motive was tax avoidance. Putting aside for the time being, until it is raised by the Commissioner, the question of whether such a rule of law actually exists and is supported by *Gregory v. Helvering*, 293 U. S. 465, the very important issue remains as to whether the factual basis for the application of such a doctrine exists in this case.

The only way to determine the answer is to ascertain what advantages would accrue to the petitioner,

Knetsch, if this Court sustained his claimed interest deductions. In other words, what is the dollars and cents effect of Knetsch's "tax avoidance" if the interest deduction (the obtaining of which was his only or primary purpose in entering into this transaction according to the Commissioner) is allowed?

The answer is that Knetsch is out of pocket $50,650.36, as a result of the instant annuity transactions even if the claimed interest deductions are allowed. (See Appendix B, *infra,* for computations.)

This is so because in 1956 Knetsch surrendered the annuities to the Sam Houston Life Insurance Company. This means that for the year 1956, if the interest deductions for 1953, 1954 and 1955 are allowed, Knetsch must report income measured by the difference between his cost basis in the annuity contracts (which could not include the interest payment to Sam Houston if they are proper interest deductions) and the fair market value of what he received upon surrender. Since Knetsch paid $4,004,000 for the ten annuities and had $4,307,000 of indebtedness cancelled upon surrender plus the receipt of $1,000 in cash thereupon, it follows that he realized gain of $304,000 upon surrender of the annuities. ($4,308,000 less $4,004,000).

The reason such gain is realized is that *any* disposition of property subject to a liability, though by a transferror not personally liable, results in the realization of the amount of the liability. *Crane v. Commissioner,* 331 U. S. 1. This principle applies even where property is abandoned, *Parker v. Delaney* (C. A. 1, 1950), 186 F. 2d 455, certiorari denied, 341 U. S. 926, or disposed of by way of foreclosure, *O'Dell & Sons Company v. Commissioner* (C. A. 3, 1948), 169 F. 2d 247,

or is condemned, *Commissioner v. Fortee Properties, Inc.* (C. A. 2, 1954), 211 F. 2d 915, certiorari denied, 348 U. S. 826. Since there is no sale or exchange upon a surrender of annuities,[3] the capital gain section cannot apply, and, therefore, the $304,000 of gain to Knetsch in 1956 is ordinary income. In fact, the U. S. Court of Claims has ruled in *Arnfeld v. United States* (Ct. Cl., 1958), 163 Fed. Supp. 865, certiorari denied 359 U. S. 943, that ordinary income is realized even where there is a sale of annuities to a third person.

Therefore, the loss of $138,315, claimed by Knetsch on his 1956 return as a result of the surrender of the annuities,[4] would be eliminated and $304,000 of ordinary income added as a result of which the additional income tax due is $269,869.21. (See Schedule 3, Appendix B). Because the total tax "avoided" as a result of interest deductions being allowed for 1953, 1954 and 1955, is $356,533.85, whereas the additional tax due upon surrender is $269,869.21, the total tax benefit can only be the difference or $86,664.64. (See Schedule 1, Appendix B). However, this is not the end of the transaction because Knetsch delivered cashier's checks for interest totaling $441,315 to Sam Houston plus $4,000 of cash upon the purchase whereas he received

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[3] I. T. 3567, 1942-2 Cum. Bull. 105; *Cohan v. Commissioner*, 1928, 11 B. T. A. 743.

[4] Knetsch's 1956 loss upon the surrender of the 10 annuities was computed by adding to the amounts paid in cash to Sam Houston each year ($441,315) the amount of cash paid at the time of purchase ($4,000) for a total of $445,315 and then subtracting therefrom the total of cash received from Sam Houston each year ($307,000) leaving the sum of $138,315. [R. 41-42.] Actually, under such an approach, the claimed loss should have been only $137,315 because Knetsch's computation did not give effect to the $1,000 of cash received from Sam Houston upon the surrender of the annuities.

in return from Sam Houston $307,000 in loan proceeds plus $1,000 upon surrender of the annuities or a total of $308,000 in cash. The difference of $137,315, therefore, is the actual cash loss to Knetsch as a result of the annuity transactions with Sam Houston. When the "tax benefit" of $86,664.64 is subtracted from this $137,315 cash loss, it is clear that Knetsch has an actual cash loss of $50,650.36 *even if* the interest deductions for 1953, 1954 and 1955 are allowed in full.

Therefore, how it can be said that Knetsch's sole or primary motive was tax avoidance which his actual cash loss is $50,650.36, even if all claimed interest deductions are allowed, is beyond petitioners' understanding. When the Commissioner urges that transactions be disregarded for tax purposes because the taxpayer's *sole* or *primary* motive was to avoid taxation, the record should certainly show, at the very least, that tax avoidance *was* the sole or primary motive. Here it seems rather strained to say that Knetsch's *sole* or *primary* motive was to escape taxation when his net worth would be $50,650.36 more if he had never purchased the instant interest deductions.

CONCLUSION.

As a result of the foregoing the decision of the court below should be reversed.

Respectfully submitted,

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August, 1960.

APPENDIX A.

Revenue Ruling 54-94

Section 23(b).—Deductions From Gross Income: Interest. Regulations 118, Section 39.23 (b)-1: Interest. Rev. Rul. 54-94

Amounts claimed as "interest" in connection with certain so-called tax savings plans the purpose of which is to obtain an interest deduction for Federal income tax purposes are not deductible under section 23(b) of the Internal Revenue Code.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23(b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1. M Insurance Company has sold to the taxpayer an "annuity savings bond" (herein called the "bond") under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000. To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity

taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, *i.e.*, the excess of the "cash value" over the unpaid balance on taxpayer's note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value".

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½ percent investment.

Example 2. In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5,000,000 United States Treasury 1⅜ percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small down payment and purported to "borrow" the balance from the N Company, a dealer in securities, on a 2¼ percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N covered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5,000,000 of such notes at the then market price to cover its short sale.

(In some cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting

the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as "interest" in the above examples are not interest within the meaning of section 23(b) of the Code, and are not deductible for Federal income tax purposes. *Cf. Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, Ct. D. 456, C. B. XI-1, 234 (1932), where the Supreme Court indicated that interest is "the amount which one has contracted to pay for the use of borrowed money."

In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest". An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See *Talbot Mills v. Commissioner*, 326 U. S. 521, Ct. D. 1660, C. B. 1946-1, 191; *Matthiessen, et al. v. Commissioner*, 194 Fed. (2d) 659. In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums paid for the an-

nuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24(a)(6) of the Code. In example 2, taxpayer in substance pays a sum of money to the N Company for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows". *Cf. Commissioner v. Transport Trading & Terminal Corp.*, 176 Fed. 2d 570, 572, where the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

APPENDIX B.

KARL F. KNETSCH — Schedule 1

Loss On Annuity And Loan Transactions

Loss on Transactions with Insurance Company		
Payments to Company		
For loan interest		$441,315.00
For part of annuity consideration		4,000.00
Total payments		$445,315.00
Receipts from company		
Proceeds of loans	$307,000.00	
Net cash surrender value	1,000.00	
Total receipts		308,000.00
Loss on Transaction with Insurance Company		$137,315.00
Federal Income Tax Benefits:		
Reduction of tax by deduction of annuity loan interest		
1953 (see Notice of Deficiency)	$113,684.48	
1954 (see Notice of Deficiency)	119,613.20	
1955 (see Schedule 2)	123,236.17	
Total	356,533.85	
Tax upon surrender of annuities in 1956 (see Schedule 3)	269,869.21	
Federal Income Tax Benefit		$ 86,664.64
Net Loss on Annuity and Loan Transaction		$ 50,650.36

Note: The above statement does not give effect to state income tax consequences, if any.

KARL F. KNETSCH

Schedule 2

Federal Income Tax Benefit Attributable to Deduction Of Annuity Loan Interest In Return For Tax Year 1955

Net income per line 5 of 1955 return	$ 92,174.39
Add: Annuity Loan Interest Deducted	150,745.00
Adjusted net income	$242,919.39
30% of Net Long Term Capital Gain	8,608.79
Ordinary Income	$234,310.60
Tax on Ordinary Income	$165,176.43
Tax on Capital Gain	4,304.40
Total Tax	$169,480.83
Tax Per Return	46,244.66
Tax Attributable to Interest Deduction	$123,236.17

KARL F. KNETSCH Schedule 3

Recomputation Of Federal Income Taxes

1956

		Without Annuity Transaction	With Annuity Transaction
Net taxable income per return		$ 6,074.58	$ 6,074.58
Add back deduction for surrender loss erroneously claimed in return if interest a proper deduction		138,315.00	138,315.00
Income upon Annuity Surrender			
Loan cancelled upon surrender			
December 11, 1953	$4,000,000		
December 16, 1953	99,000		
December 30, 1954	104,000		
December, 1955	104,000		
Total	$4,307,000		
Cash received upon surrender	1,000		
Total Received	$4,308,000		
Cost basis of annuity contract	4,004,000		
Gain on surrender			$304,000.00
Adjusted net taxable income		$144,389.58	$448,389.58
50% of long term capital gain		97.50	97.50
Ordinary income		144,292.08	448,292.08
Federal Income Tax			
On ordinary income		$ 47,716.58	$357,585.79
On capital gain		48.75	48.75
Total		$ 87,765.33	$357,634.54
			87,765.33
Federal Income Tax upon Surrender of Annuities			$269,869.21